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ABSTRACT

This report summarizes the programs in the 15 states of the Southern Regional Education Board (SREB) designed to help parents provide for future college costs. It differentiates between college savings plans, bond programs, and prepaid tuition plans. Differences in the programs of the various states are discussed, such as who can buy a prepaid tuition contract, who may benefit, what contingencies may arise, and refund policies. Federal and state tax implications are mentioned. Recommendations cover the issues that should be explored as states consider prepaid tuition or college savings programs: (1) whether the benefits and requirements of the plan are clear and easy to understand; (2) who the plan is targeting and outreach effectiveness; (3) accommodation for those in the most financial need; (4) data collection for program evaluation; (5) necessity for clearly communicating to the public that benefits cover only a portion of the total cost of attending college? (6) effects of program participation on student eligibility for financial aid; and (7) effects of plans on future college-going rates and enrollment trends. (DB)

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TO THE EDUCATIONAL RESOURCES INFORMATION CENTER (ERIC)

Planning for Future College Costs in the SREB States

Families facing the prospect of a child going to college become painfully aware of the expense involved. The costs are daunting and there doesn't appear to be relief in sight. Several facts summarize the dilemma:

- Tuition is increasing faster than household income and consumer prices;
- To pay tuition, families give up a greater proportion of their income;
- Tuition is making up a greater portion of college operating budgets and putting more of a burden on families;
- Financial aid programs are increasingly loan-oriented and middle-income families are being squeezed out of eligibility;
- Federal grants that once covered 80 percent of college costs now cover less than half.

State policy makers recognize that these factors are pushing a college education out of reach for many students and their families at a time when an education beyond high school is increasingly important. Through caps and restraints on tuition increases, optional payment plans, state scholarship programs, tuition savings plans and prepaid tuition programs, policy makers hope to stem spiraling costs and provide a means for families to plan for and meet future costs.

In response to these issues, most SREB states have created either college savings plans or prepaid tuition programs, also known as guaranteed tuition programs. Some states initially began one type of plan then created another a few years later. For example, Tennessee, Texas and Virginia all implemented savings bond programs in the late 1980s. By the mid 1990s, all had also established prepaid tuition plans. Louisiana initially passed a guaranteed tuition program in 1989 but it was replaced with a savings program in 1995.

This report was prepared by Gale Gaines, Associate Director for State Services. For further information, call (404) 875-9211.

College savings programs

College savings programs established by SREB states have taken two forms, bond programs and savings plans. Bond programs generally sell bonds at a discounted price that can be redeemed at full face value at maturity (generally $1,000 to $5,000) in 5, 10 or 20 years. In North Carolina, for example, a $5,000 bond with a redemption date of 2009 was sold for $1,293 in 1989. Among SREB states, Arkansas, North Carolina, Tennessee, Texas and Virginia, have offered bond sales to help families save for future higher education costs. Arkansas has also sold current-interest bonds that pay interest periodically thoughout the life of the commitment.

Bond programs do encourage savings for college expenses, and they can be redeemed for use at practically all higher education institutions. They may be attractive to small investors, but they are not guaranteed to keep pace with rising costs and are expensive to issue due to their small denominations and the special marketing efforts needed to tell the public about them.

College savings plans are underway or authorized in Kentucky, Louisiana and North Carolina. Kentucky's program is the only one in the region in operation. Newer programs in Louisiana and North Carolina should get underway this summer or fall. The legislature in Oklahoma is considering a bill to create a tuition savings program.

These programs are designed to provide a way to cover at least part of future college costs through deposits to special college savings accounts. According to the National Association of State Treasurers, college savings programs generally allow persons to deposit funds in increments as small as $25 and guarantee a rate of return of at least 4 percent. In addition, interest earned is not subject to state income taxes but is subject to federal taxes. Another benefit of these programs is that savings and interest earnings can be used for college costs beyond tuition and mandatory fees, which are clearly less than half the cost of attending college.

College Savings Programs in the SREB States *

* Underway or authorized

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START Saving in Louisiana

Louisiana's Student Tuition Assistance and Revenue Trust Program (START) is reportedly the first savings program of its kind in the country. Created through 1995 legislation, the program is due to begin this July. When a savings account is opened, either the owner of the account or the beneficiary must be a state resident. What is unique about the program is that the state will provide an annual matching grant for deposits made during the year. The state match is recorded in the beneficiary's college savings account and begins accruing interest with the original deposits. The state match is based on family income. According to the graduated scale outlined in law, the state will pay 14 percent of the annual savings into the account if the owner's income falls below $14,999, 12 percent if the income is between $15,000 and $29,999, and so on, down to 4 percent for income falling between $75,000 and $99,999.

Prepaid tuition plans

Prepaid tuition plans appear to be more popular since the benefits are designed to provide future costs of tuition and mandatory fees. In fact, roughly half the nation's authorized plans are in SREB states. The prepaid tuition programs call for a lump sum payment or a structured payment schedule based on the age of the beneficiary, the number of years of tuition and fees desired and length of payment schedule.

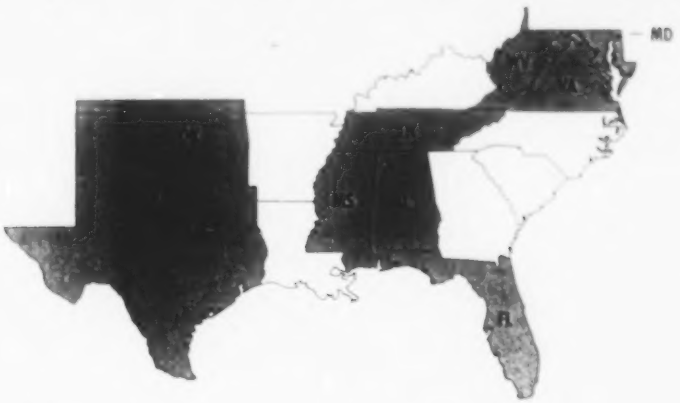
Ideally, when all payments have been completed, benefits provide tuition and mandatory fees for up to four years of college. Mandatory fees are defined as those required as a condition of enrollment for all students. They do not include, for example, room, board, laboratory fees, individual course or optional fees. Prepaid contracts do not guarantee admission to college — students must meet admission requirements of the colleges they wish to attend.

Six SREB states (Alabama, Florida, Mississippi, Tennessee, Texas and Virginia) operate prepayment programs and 1997 laws authorize the creation of programs in Maryland and West Virginia. South Carolina has prepayment legislation under consideration. Oklahoma has an early prepayment law on the books but did not implement it because of federal tax issues that have recently been settled. A legislative resolution under discussion in calls for a study of prepaid tuition plans.

Several studies have reported a number of advantages associated with prepaid tuition programs:

- They set a structured savings program for future costs;
- Purchasers can pay current tuition rates and lock in future benefits;
- Flexible payment schedules allow low monthly payments;
- Benefits can be transferred to alternate beneficiaries;
- Plans can be used at independent colleges or out-of-state schools.

Prepaid Tuition Programs in the SREB States *



* Underway or authorized

But the National Association of State Treasurers has expressed some concerns:

- Prepaid tuition programs may be seen as tax shelters for the wealthy;
- Purchasers might get a better return for their money in other investments;
- There is some risk to the state when its credit is pledged as a guarantee;
- Participation could affect eligibility for federal and other need-based financial aid programs.

In addition, some programs are not guaranteed by the state and there is some risk to the individual investor.

It is unclear at this time what impact these programs will have on college-going rates or on enrollment trends in the region's colleges. While the plans do not guarantee admission, there is a certain inherent incentive for doing well in school if the student knows that tuition and fees have been paid. In Florida and Texas, the largest group of beneficiaries has been under age one at the time of

Michigan Tackles Federal Tax Issues

Michigan began the first prepaid tuition program in the country in 1988. Known as MET (the Michigan Education Trust), the program initially was not given tax-exempt status by the Internal Revenue Service because it was not clear that the program was an "essential function of the state." Michigan challenged the IRS ruling in federal appeals court and won. The IRS also wanted to tax contract purchasers annually for investment earnings. The Small Business Job Protection Act of 1996 clarified the qualifications for tax-exempt status and deferred taxes on earnings until benefits from the programs are actually used. Earnings will be taxed based on the student's income, which is presumed to be lower than that of the purchaser. Federal legislation under consideration would make the benefits tax exempt in total.

purchase. Projections have not been made as to the possible effect on university enrollments though some state officials have expressed concern about being able to meet the needs of growing numbers of students.

Georgia has taken a different approach to planning for college costs. Created in 1993, the HOPE Scholarship Program pays tuition, mandatory fees and a book allowance to students attending public colleges. Students must graduate from high school with a "B" average in their core academic courses and maintain a "B" average in college. One of the impacts of the HOPE program is the increased likelihood that Georgia students will attend in-state colleges. Colleges in neighboring states are enrolling fewer of Georgia's top students and first-year student enrollments are up at Georgia universities that offer doctoral programs.

There are many questions asked about prepaid tuition programs. The answers provide an overall picture of how they operate.

Who can buy a prepaid tuition contract and for whom?

In Alabama, Florida and Texas, anyone is eligible to purchase a prepaid contract. However, the beneficiary must be a state resident at the time of the purchase or the child of a parent who is a state resident. In Texas, if the child is not a resident, the resident parent must purchase the contract.

Maryland, Mississippi, Tennessee and Virginia require either the purchaser or the beneficiary to be a resident at the time of purchase. Purchasers in Mississippi must be parents, grandparents or legal guardians. Until 1997 when legislation was approved in Tennessee and Virginia, the child was required to be a state resident. A child of a state resident is eligible to be a beneficiary, whether or not the child lives in the state.

Because most programs are relatively new, there is little information available that provides a clear picture of who is purchasing contracts. Texas reports that 40 percent of those who purchase contracts hold bachelor's degrees and 20 percent have received master's degrees. Parents are most often the purchasers — cornering 86 percent of the sales — while grandparents make up 12 percent.

Income information on purchasers is difficult to obtain because high percentages of applicants choose not to respond. In Texas, 23 percent did not report income information and 50 percent reported family incomes exceeding $50,000. In Florida, 44 percent of applicants did not respond to income questions. Of those buying contracts, 16 percent had family incomes exceeding $50,000; 26 percent had incomes falling between $30,000 and $50,000; and 14 percent reported income levels below $30,000.

In all plans except Tennessee's, a contract is guaranteed to pay for, in the future, from one to five years of tuition and mandatory fees at any in-state college regardless of cost increases. The idea is that investment earnings will make up the difference between the contract payments and the actual tuition and fees at the time the child enters college.

What is bought and how is it paid for?

Programs in Florida, Maryland and Mississippi offer several plans including a two-year community college plan, a four-year university plan and a 2 + 2 plan that covers two years at a community college and two years at a university. Alabama's program involves only one type of contract that provides four years of tuition and mandatory fees. Most states limit the benefits to a certain number of credit hours. Four-year contracts in Texas, for example, pay for 128 credit hours, while those in Alabama and Florida cover 135 and 120 credit hours, respectively.

Virginia allows individual years of tuition and fees at any public college in the state to be purchased so that someone can buy one or two years at a community college, one to five years at a four-year school or a combination of the two plans. Fifth year benefits can be applied to graduate classes though the benefit paid is based on undergraduate tuition rates. Students would pay the difference between the graduate fees and the undergraduate benefit paid. A 1997 law under consideration in Texas would also allow a fifth year to be purchased. Texas currently allows purchasers to buy from one to four years of tuition and fees at public colleges, but also offers a private college plan based on the estimated average tuition and fees at independent colleges in the state.

In Tennessee, units are purchased rather than years. Each unit represents roughly one percent of the weighted average cost of tuition and mandatory fees for one year. This means that 100 units would presumable pay for one year of college if actuarial projections are met and if tuition at the institution selected were below the statewide average. The

Prepaid Tuition Contracts Available in the SREB States

State	2-year	4-year	2+2	Other
Alabama		✓		
Florida	✓	✓	✓	
Maryland	✓	✓	✓	
Mississippi	✓	✓	✓	
Tennessee				Units
Texas	✓	✓	✓	Single years may be bought; private college plan is available
Virginia	✓	✓	✓	Single years may be bought; a fifth year is available

Notes: Oklahoma has not implemented 1988 legislation creating a prepaid tuition program.

In West Virginia, 1997 legislation requires the prepaid tuition board of trustees to present a plan for implementing the program to the legislature by its 1998 session.

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price of a unit is based on 1 percent of the current average tuition plus an additional amount for administrative fees and actuarial projections. Unit costs change as actuarial projections and tuition change. In the fall of 1996, the purchase price for each unit was $22.50 and will rise to $24.50 by November 1997. If the child enrolls in a college where tuition and required fees are above the statewide average, more than 100 units would be needed to pay for one year.

Prepaid tuition plans provide flexibility to purchasers by offering payment schedules designed to fit nearly every family budget. While details of newly-adopted programs are not yet available, the states where programs are underway offer options that include a single lump-sum payment that roughly approximates current tuition and fees, payments over five years (55 to 60 monthly payments), or monthly payments from the time a contract is purchased until the child reaches the estimated date of college enrollment. In addition, Texas offers a 10-year payment plan that calls for 120 monthly payments. Purchase prices in all of the programs take into consideration actuarial projections of interest earnings and what tuition and fees are estimated to be at the time a student enters college as well as the type of plan purchased, the age of the beneficiary and the payment schedule selected.

Both Florida and Texas report similar findings on what types of plans are purchased. Most often, four-year college plans are bought, with the next most popular being the 2 + 2 plans (two years of community college plus two years at a four-year school). In Florida, 75 percent of contracts cover four-years at a senior college and 20 percent involve the 2 + 2 arrangement, while in Texas, similar figures are 81 percent and 12 percent, respectively. Texas also reports that on 44 percent of the contracts, payments are made monthly until the child graduates from high school and 23 percent make a single lump-sum payment.

Are the plans guaranteed?

There are two issues to look for in plan guarantees: first, whether the soundness of the investment fund is guaranteed by the state, and second, what exactly the contract guarantees should investments be insufficient to assure benefits. While each of the prepaid tuition programs was created through state legislation, not all are guaranteed by the states. Of the programs authorized in the region, only those in Florida and Mississippi are currently backed with the full faith and credit of the state—which means, the state is obligated to appropriate monies to cover shortfalls in the investment fund. Legislation passed this year in Texas will place a proposed constitutional amendment on the ballot in November to allow voters to determine if the state should guarantee the program.

Alabama, Maryland, Tennessee, Texas, Virginia and West Virginia are not obligated to bail out the fund should a shortfall occur. Contract payments, however, are generally invested in safe markets. In Texas, for example, investments are made in markets that are backed by the

federal government. In addition, the programs undergo regular audits and projections are made annually to determine the stability of the fund and prices for the next enrollment period.

Purchasers often want to know what happens to their contracts if the investment market drops. The boards governing prepayment programs have the authority to suspend the programs, if necessary, should the investment fund become unsound. In most cases, the contracts address redemption or refunds should this occur.

In Florida and Mississippi, the state guarantees that if the programs are discontinued, any beneficiary who is within five years of enrolling in college will receive complete contract benefits. Younger beneficiaries will receive as a refund the original amount paid plus interest at prevailing rates for savings accounts. Currently, Texas law specifies that should the program be terminated, anyone within three years of entering college would receive full benefits. Refunds to other contract holders, however, are totally up to the Texas Tomorrow Fund Board.

In Virginia, the sale of contracts may be suspended but those already purchased will be honored. If actuarial estimates prove to be inadequate to maintain program soundness, the Tennessee program will be suspended and refunds will be issued. The board of directors of Alabama's program has not determined a policy should the program be terminated.

What happens if a beneficiary does not go to college?

Plans in the SREB states include contingencies for students who, upon graduating from high school, choose not to attend college. The programs generally allow the contract to be transferred to another qualified beneficiary, such as a brother or sister. A refund can also be obtained, though at a premium, because these programs are not traditional savings programs and therefore, do not earn interest like a traditional savings account.

Should a transfer of benefits not be desired or feasible, refund policies in Alabama, Florida and Virginia provide the purchaser with the amount of the payments made, less fees (generally $50 to $150) with no interest or earnings paid. Mississippi will pay principal plus interest less a cancellation fee of up to $150. Texas will pay either the lowest tuition and fees in the state's colleges or the amount of payments plus earnings, whichever is less. Units will be refunded in Tennessee at their current value less a 50 percent penalty on the increase in value over the original purchase price.

Refund policies make special provisions in the case of death or disability of the beneficiary. In most cases, states pay either the current value of tuition and fees or the sum of the payments made plus interest earnings.

Can a prepaid plan be used to attend independent or out-of-state colleges?

Prepayment plans are portable for students choosing to attend a private or out-of-state college. States generally pay an amount equal to the average of in-state tuition and fees for the plan chosen (such as community college or senior college). Students are then responsible for paying the difference between the benefit paid and the actual cost at the selected college.

Florida and Virginia make a distinction between in-state private colleges and out-of-state schools in the benefits paid. In Florida, in-state independent colleges receive the average cost of tuition and fees at the time of the student's enrollment for the plan purchased while out-of-state colleges receive either the tuition rate or the amount paid into the plan plus 5 percent interest, whichever is lower.

Virginia will pay the amount paid into the plan plus actual interest earned to help cover the cost for students attending an in-state private college. However, the payment is not to exceed the highest tuition at public colleges in the same year. The benefit for students attending schools outside of Virginia equals the sum of the payments made plus a reasonable return as determined by the board, but not to exceed the highest tuition at a public college.

What about financial aid?

While tuition prepayment programs are not estimated to have any impact on merit scholarships, there is a potential effect on eligibility for need-based aid. Program brochures in several states clarify that the plans are not treated as a family asset on federal financial aid forms, but they are treated as an additional resource to the student, which may impact eligibility.

Prepayment plans make provisions in the contract for students receiving scholarships. Alabama, Tennessee and Texas will refund the tuition and fee rates in place at the time the scholarship is used. Mississippi and Virginia will pay to the purchaser the principal paid in plus interest less an administrative or refund fee. Florida will provide the amount paid to the fund plus 5 percent interest or the value of tuition, whichever is less.

What if a beneficiary moves out of state?

What happens if I move my family to another state? Does my child remain a resident of the state for tuition purposes? This is a common question asked by many considering the purchase of a tuition contract. In Florida, Mississippi and Texas, once a contract is purchased for a qualified beneficiary, the child remains eligible for in-state tuition regardless of where he or she lives prior

to entering college. Alabama, Tennessee and Virginia require the beneficiary to meet residency requirements or pay the difference between the benefits provided by the contract (in-state tuition) and the out-of-state charges. In Maryland, beneficiaries who live outside the state must meet residency requirements set by the institution they plan to attend. If a student does not meet the college's definition of a resident, he will be required to pay the difference between in-state and the out-of-state tuition and fee rates.

Looking ahead

Prepaid tuition and college savings programs are becoming a popular way to plan for college costs and at the same time, make attending college a priority for young people across the region. It is too early to tell what effect these programs will have on college-going rates or on enrollment trends in the SREB states. It is hoped they will make college affordable for more students and families. As states consider creating prepaid tuition or college savings programs, or review existing programs, a number of questions should be explored:

- Are the benefits and requirements of the plan clear and easy to understand?
- Who is the plan targeting and are they being reached?
- Does the plan accommodate those in the most financial need?
- What information should be collected to determine program effectiveness?
- Is it clear to the public that benefits cover only a portion of the total cost of attending college?
- What effect will participation in the plan have on student eligibility for financial aid?
- How will these plans affect future college-going rates and enrollment trends in the state?

Selected Resources

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